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IN THE

Supreme Court of the United States

OCTOBER TERM, A. D. 1941.

No. 608

MILTON H. FRIEND, BERTHA F. LEVY AND ETHEL PACYNA, AS TRUSTEES OF THE TRUST ESTATE CREATED UNDER THE LAST WILL AND TESTAMENT OF HENRY FRIEND, DECEASED,

Petitioners,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

PETITIONERS' REPLY BRIEF.

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PETITIONERS' REPLY BRIEF.

The "Brief for the Respondent in Opposition" is not responsive. It is not pertinent to the issue determined by the United States Circuit Court of Appeals nor that raised by the petition for certiorari.

The question as stated by respondent and the argument in respondent's brief relate to one of the several alternative theories suggested by the petitioners before the United States Board of Tax Appeals but abandoned in the oral argument before the United States Circuit Court of Appeals.

Stated simply, petitioners' position is as follows:

The petitioners are Trustees of the Estate of Henry Friend, who died on August 1, 1932. They acquired as part of the estate of the decedent certain real estate im-

proved and subject to long-term leases. At the time the leases had been made by the decedent, rent levels were substantially higher than on the date of his death. As a result, the date-of-death value of the property here in question, as determined for Federal estate tax purposes and as established in the hearings before the United States Board of Tax Appeals herein, was in excess of the value of the naked land, unimproved and unleased. In fact, the evidence established that there were two values involved in this property: the one, the value of the naked land, and the other, the capitalized value of the rentals payable under the lease over and above the rental value of the naked land. The existence of this excess value over the value of the land has not been contested. Respondent has conceded that, if the petitioners had purchased this property, land plus the interest of the lessors under the leases, at such date-of-death values, petitioners would be entitled to annual deductions for depreciation or amortization of the excess value over the value of the land.

The only issue left for consideration of the United States Circuit Court of Appeals was this question: Do the petitioners have any lesser right to such annual deductions for depreciation or amortization by reason of the fact that the land plus the lessors' interest were acquired by *inheritance* rather than by *purchase?*

It may be desirable to correct at the outset the erroneous references in respondent's brief (and also in the opinion of the Circuit Court of Appeals) to division of the property inherited into lessors' interest under the leases and reversions. Obviously, the inheritor of real estate subject to a lease could describe the property inherited in this manner. Both such interests could be separately valued. Petitioners believed, however, that such a separation might not be regarded as having sufficient reality for the practicalities of taxation and therefore adopted and urged be-

fore the Circuit Court of Appeals the more realistic concept referred to above, viz.: Did the naked land as of the date of death have a value different from that of the land in its improved and leased state? If the existence of the advantageous leases on the date of death established a value by reason of the rental "annuities" in the leases in excess of the value of the naked land, that excess value necessarily would terminate with the termination of the leases, and that value would, therefore, disappear by reason of the mere lapse of time. Petitioners were not and are not contending for the right to amortize the capitalized value of the *total* rentals under the leases without reference to the value of the land. That would be the gist of the lessors'-interest-plus-reversion argument referred to by the respondent. The petitioners are asking only the right to amortize that value on the date of death—under the Federal estate tax laws—which is in excess of the inexhaustible land and which will inevitably disappear with the extinction of the leases by lapse of time. This excess value the Commissioner concedes would be amortizable if it had been purchased for cash. The Circuit Court of Appeals appears to agree that basis exists with respect to this excess value for purposes of *gain or loss* even though inherited. Petitioners contend that it exists even though inherited for purposes of *depreciation or amortization.*

The situation is not distinguishable from that involved in the inheritance of land-and-buildings, which is merely another combination of exhaustible and inexhaustible assets expressly required to be separately valued and the exhaustible portion depreciated, in Article 23(l)-4 of respondent's Regulations 86 under the Revenue Act of 1934 quoted in the footnote.*

* ART. 23(1)-4. *Capital sum recoverable through depreciation allowances.*—The capital sum to be replaced by depreciation allowances is the cost or other basis of the property in respect of which the allowance is made. (See sections 113(a) and 114) * * * In the case of the acquisition on or after March 1, 1913, of a combination of depreciable and non-depreciable property for a lump price, as, for

Perhaps a few examples will be helpful. Suppose two men purchase parcels of real estate A and B which are identical except that A is improved with a valuable building and B is bare. Plainly, A's purchase price (and hence basis) will normally exceed B's purchase price by an amount equal to the value of the building. It is known, however, that the building is exhaustible and will become worthless within a definable period, and at the end of that time A and B will be identical in every respect. Clearly the basis for these two identical parcels after the building becomes worthless should be the same and, hence, under the tax law, the value in A attributable to the exhaustible building is eliminated from the basis by depreciation during the building's life. Exactly the same rule would be applicable if, instead of being purchased, A and B were acquired by inheritance, the only difference being that the basis, both with respect to the land and with respect to the building, would be the value on the date of death rather than the purchase price.

Now, suppose that A is unimproved but has theretofore been leased under a long-term lease to a responsible lessee at rentals substantially in excess of the rentals which could be realized if a new lease were to be made at the time of acquisition. Here also, A's purchase price would be more than B's purchase price, since A's purchaser would be deriving greater revenue than B's purchaser. Similarly, if these properties are inherited, the date-of-death value (or basis) of A would be greater than that of B. Here again, however, the factor with respect to A which makes

example, buildings and land, the capital sum to be replaced is limited to an amount which bears the same proportion to the lump price as the value of the depreciable property at the time of acquisition bears to the value of the entire property at that time.

The fact that the depreciable portion of the property here involved is intangible (right to receive rents) rather than tangible (buildings) as mentioned in the above example, is irrelevant. Article 23(l)-3 of Regulations 86 provides, in part, as follows:

ART. 23(l)-3. *Depreciation of intangible property.*—Intangibles, the use of which in the trade or business is definitely limited in duration, may be the subject of a depreciation allowance.

its basis greater than the basis of B is the lessor's interest under the lease, which will become worthless within a period ascertainable at the date of acquisition. At the end of this period, again A and B will be identical, and at that time their bases should be identical. The excess in A's value over B's value must be written off by depreciation during the life of the item of exhaustible property representing the excess value, whether tangible, as in the case of the building, or intangible, as in the case of the lease. In the one case the tangible improvement is in a sense an incident of the fee. Similarly, in the case of the lessors' interest under the lease, it may be regarded as an incident of the fee. But in both cases these exhaustible incidents are readily susceptible of separate valuation for purposes of allocation of purchase price or of date-of-death values.

In the case at hand, at the date of death there existed not only such advantageous leases representing a rental value over the naked land, but in addition, the land was actually improved with valuable buildings. In addition, the evidence before the Board of Tax Appeals clearly established these separate date-of-death values for the land and the excess value for the exhaustible rights against the lessees. There is not a word in respondent's brief which mentions these facts.

Let us examine respondent's brief.

On page 2 respondent purports to state the "question presented" but omits the all-important distinguishing fact that in this case the long-term leases represented, at the date of the decedent's death, a value in excess of the value of the naked land on that date, and omits also mention of the fact that the property in the lease contracts with respect to which depreciation or amortization is sought is this excess exhaustible value.

On pages 2 to 4, in quoting pertinent provisions of the law and regulations, respondent omits mention of Section

114(a) of the Revenue Act of 1934, the crucial section which makes Section 113(a)(5) of that Act (which respondent quotes) applicable for purposes of *depreciation* as well as for purposes of *gain or loss.*

Pages 4 to 6 of respondent's brief erroneously state as petitioners' contention the alternative position abandoned before the Circuit Court of Appeals and not here involved. Attention is particularly directed to the paragraph beginning at the bottom of page 5 and carrying over to page 6. This paragraph (except for the last sentence) is virtually a quotation of the first few sentences of the opinion of the Board of Tax Appeals herein (R. 182), which paraphrased this abandoned alternative argument. No mention is made in respondent's brief of petitioners' primary position, which is paraphrased in the immediately succeeding paragraph of the opinion of the Board of Tax Appeals herein as follows (R. 183):

> "In the alternative they make the contention that the business depression was at a very low point on August 1, 1932; that on the [that] date a reasonable and fair rental for the land at 6308-6310 South Halsted Street, unimproved and unencumbered by any lease, would have been $14,000 per annum net to the owner [under] a lease of 30 years or more, sufficient to make it worth while for the lessee to erect a suitable improvement; and that on the same date a reasonable and fair rental for the land at 6312-6314 South Halsted Street, unimproved and unencumbered by any lease, would have been $12,500 per annum net to the owner under a least [lease] of 30 years or more. They then contend that the excess rental receivable by the estate under the terms of the leases was amortizable over the terms of the leases. Upon this basis they contend that the excess rental receivable on the Kresge property had a value on August 1, 1932, or [of] $49,940 and on the Woolworth property $67,575 plus the present value of an annuity of $12,500 per year for 25 years commencing 16 years and 5 months after August 1, 1932, the life of the second Woolworth lease, or

> $37,760. Upon this alternative basis they claim that the amortization deductible in each of the years 1934 and 1935 was $5,600."

Obviously if, as the Board stated and the evidence conclusively shows, a reasonable and fair rental for the inexhaustible land of the Halsted properties on the date of the decedent's death totalled $26,500 a year and the actual rentals under the exhaustible leases which the petitioners inherited, as stated by the Board (R. 182) and the respondent (brief, page 5), was between $38,000 and $43,000 a year, there was property of value at the date of the decedent's death represented by the definite right to receive up to $16,500 a year in excess of what could have been realized from the inexhaustible ground, and the life of this property as well as its value was definitely known.

The bulk of respondent's argument (pages 6 to 8) is simply a reliance upon the recent decision of this court in *Hort* v. *Commissioner*, 313 U. S. 28, 85 L. Ed. 706 (3/31/41). The *Hort* case did not involve and did not decide any issue related to the issue here involved. In the *Hort* case the taxpayer's father had entered into a lease on August 31, 1927 covering certain bank premises in New York City. The father died on March 7, 1928, devising the premises, together with the lease, to the taxpayer. Thus, the valuation date for determining the basis to the taxpayer of the premises-and-lease in the *Hort* case was 1928, when the lease may have been advantageous to the lessee rather than the lessor, and certainly could not have represented excess value over the rentable value of the premises at the time of the father's death. The important fact is that nowhere in the record or briefs in the *Hort* case before this Court is there any suggestion that the value *on the date of the father's death* of the premises-and-lease was in excess of the value on that date of the premises alone.

Perhaps the difference between the *Hort* case and the

present case can be illustrated by a further example. Suppose a taxpayer receives by inheritance a parcel of land on which is a building which has no economic value at the time of the decedent's death, or, in other words, suppose that the value of land-and-building is equal to or less than the value of the land alone. Here the building has no basis and is not subject to depreciation. Suppose, on the other hand, that the building has substantial value at the date of decedent's death, or, in other words, that the value of the land-and-building is substantially in excess of the value of the land alone. Here the building has a basis equal to its value over and above the value of the naked land and is depreciable to that extent. To say that the decision in the first example is controlling in the second example would be absurd. Yet, such an argument is indistinguishable from the argument which respondent attempts to make based upon the *Hort* case.

In his discussion of the *Hort* case on page 7 of his brief, respondent states that the lease involved in that case was "advantageous." Of course, it was advantageous in 1933, when the lessee paid a substantial amount to be relieved from its burdens. 1933, however, was not the valuation date for purposes of determining *basis*. That valuation date was March 7, 1928, barely six months after the execution of the lease, and there was no showing or attempt to show that the lease was advantageous to the lessor on that date. In the present case, however, the critical valuation date for the purpose of determining basis (date of death) is August 1, 1932, and the record abundantly established that on that date the leases were advantageous and that the lessor's interests under the leases had substantial values in excess of the value of the naked land.

The issue in the *Hort* case was simple. The sole contention made by the taxpayer in that case was that at the time of the cancellation of the lease the taxpayer had in

contemplation the receipt, for approximately thirteen years thereafter, of rent with respect to the premises in question in excess of the then rentable value of the land. In view of the high real estate values on the basic valuation date in that case, namely, 1928, it was not contended and could not have been contended that if these rents had actually been received they would not have constituted fully taxable income. The sole argument which the taxpayer did make and could make was that the receipt in advance of a lump sum for termination of the lease, which was less (even when augmented by the then rental value of the premises) than the income which the lease contract provided to be payable over a period of years, constituted a loss. As this Court emphasized several times in its opinion, this argument was denied solely on the ground that the advance payment was simply a substitute for payments in the future which would admittedly constitute income. This Court stated (85 L. Ed. at 709):

> "The cancellation of the lease involved nothing more than relinquishment of the right to future rental payments in return for a present substitute payment and possession of the leased premises. Undoubtedly it diminished the amount of gross income petitioner expected to realize, but to that extent he was relieved of the duty to pay income tax. Nothing in Sec. 23(e), 26 U. S. C. A. Int. Rev. Acts, 1940 ed. p. 490, indicates that Congress intended to allow petitioner to reduce ordinary income actually received and reported by *the amount of income he failed to realize.*" (Italics added.)

The Board of Tax Appeals, whose decision was affirmed by this Court in the *Hort* case, rested its conclusions upon the fact that the lease had no basis and that no value was shown for the lease *as of the date of death* in that case over and above the value of the land and building. The Board stated as follows (39 B. T. A. 922, 925-926 (1939)):

> "The petitioner has failed to prove any figures from

which a loss could be computed. A loss from the disposition of property is computed for income tax purposes by deducting the amount realized from the adjusted basis. The amount realized from the cancellation of the lease was $140,000. Basis is always cost or some substitute therefor authorized by the revenue act. *Where, as here, property was acquired by bequest in 1928, the basis would be the fair market value of the property in 1928. The evidence does not show any separate basis for the lease in question in the hands of this petitioner or that the lease had any value in itself at the time that the property was acquired by this petitioner.*" (Italics added.)

The plain implication of this language is that if the evidence had shown that the lease had separate value on the basic valuation date, namely, the date of death, it would have had a separate basis for tax purposes and such basis would be taken into consideration in determining gain or loss. The same point of view is indicated in the Commissioner's brief before this Court in the *Hort* case in which it is stated, at pages 6-8:

> "Leases may or may not, depending upon the circumstances of each case, be property which is to be considered as capital in the hands of the taxpayer. A taxpayer who paid $100,000 for an assignment of the lessor's interest in a lease would have a capital investment of $100,000 in that lease; if it were cancelled the next day in return for a payment by the lessee of $100,000, the taxpayer would obviously have realized no gain. On the other hand, if a taxpayer makes a lease on his own property one day and several days later agrees to cancel the lease, or assigns the lease, in return for the payment to him of $100,000, he obviously realizes income of $100,000 because the lease does not represent capital in his hands. He has not spent anything to acquire the lease and the rental obligation cancelled or assigned has not been received and reported as income by him.
>
> The present case must be decided in the light of these principles. The taxpayer may prevail only if he can

show that the cancelled lease was property which, in his hands, represented capital. This showing he cannot make. The lease was plainly not capital in the hands of petitioner's father, and it was not transmuted into capital upon the father's death in 1928. *The record does not show whether in 1928 the lease had any value;* whatever value it might have had was not reported separately in the estate-tax return but was simply reflected as part of the $650,000 valuation placed upon the land and building. Thereafter the tax basis of the property in the hands of petitioner was $650,000; for purposes of income-tax accounting, however, that tax basis is ascribed entirely to the land and building, which alone are considered as capital assets, the leases being treated as purely income items with a tax basis of zero.

Furthermore, petitioner has failed to show that in 1928 the Irving Trust Company lease, to commence in 1932, was of any value at all. Consequently, even if the lease be treated as a capital asset, it would still be property with a tax basis of zero and its disposition would therefore still result in gain to the full extent of the consideration received." (Italics added.)

In the present case the evidence of excess value in the leases is clear, is not contested by the respondent, and is assumed both by the Board of Tax Appeals and the Circuit Court of Appeals. Furthermore, in the present case, in contrast to the *Hort* case, the lease and land were separately valued for purposes of the federal estate tax (R. 182).

One of the cases repeatedly relied upon by the Commissioner before this Court in the *Hort* case and relied upon by the Circuit Court of Appeals for the Second Circuit in *Warren Service Corporation* v. *Helvering*, 110 F. (2d) 723 (C. C. A. 2d 1940), upon which the decision of the Circuit Court of Appeals in the *Hort* case was summarily based, is *Josey* v. *Commissioner*, 104 F. (2d) 453 (C. C. A. 10th 1939). In the *Josey* case the facts were similar to those in the *Hort* case with one additional important fac-

tor, viz., the taxpayer acquired the lessor's rights under the lease in question by purchase for $50,000. This $50,000 the taxpayer wrote off by depreciation or amortization deductions year by year, and this practice was approved by the Commissioner and the Circuit Court of Appeals. The Circuit Court of Appeals stated (104 F. (2d) 455-56):

> "Under Section 23(a) of the Revenue Act of 1934, 48 Stat. 688, 26 U. S. C. A. Sec. 23 (a), and Art. 23(a)(10), Tr. Rep. 86, Josey is entitled to an amortization deduction of an aliquot part of the $50,000 paid by him for one-half interest in the lease each year until the entire cost has been amortized. * * *
>
> * * * * *
>
> Since Josey will eventually receive through amortization deductions the entire cost of $50,000, the disallowance of a loss deduction will result in no injustice to him."

Thus, not only does the present case lack the one essential element upon which the *Hort* decision was based (namely, advance payment in lieu of income) and include the one essential element which the *Hort* case lacked (namely, excess value in the exhaustible leases on the basic valuation date—date of death), but also one of the principal cases upon which the respondent relied in the *Hort* case, namely, the *Josey* case, is in conflict with the decision in the case at bar, and for this reason, if for none other, the writ of certiorari should be granted.

Contrary to the statement on page 7 of respondent's brief, the statutory provisions here invoked were not available in the *Hort* case because there was no element of excess exhaustible value in the lease in the *Hort* case on the date of the decedent's death, which, in that case as well as in this case, was the basic valuation date.

In the last paragraph of respondent's brief, fleeting mention is made for the first time of the real issue set forth in petitioners' petition for certiorari, namely, that the Cir-

cuit Court of Appeals has decided this case upon the holding that Section 113(a)(5) provides a basis only for gain or loss and not for depreciation. No reference is made to the opinion of the Circuit Court of Appeals to support respondent's contention that the petitioners "have misconceived the basis for the decision below." No explanation is made of the second paragraph on R. 215, in which the Circuit Court of Appeals stated that the petitioners may not rely upon Section 113(a)(5) of the Revenue Act of 1934 to furnish a basis for amortization because the basis provided in that section is merely a basis for gain or loss.

Conclusion.

It can serve no useful purpose to review herein the authorities cited in petitioners' brief in support of their petition for certiorari. Neither these authorities nor indeed any of the arguments presented by petitioners have been considered in respondent's brief. The only authority cited by respondent, namely, *Hort* v. *Commissioner*, 313 U. S. 28, 85 L. Ed. 706 (3/13/31), did not involve the fundamental facts involved herein, namely, excess exhaustible values on the date of death, and did not involve, expressly or implicitly, the position urged by the petitioners herein.

It is respectfully submitted that, as stated in the petition for certiorari, the decision of the United States Circuit Court of Appeals is in conflict with the applicable decisions of this Court and other Circuit Courts of Appeals and in direct contradiction of the unambiguous language of the appropriate statute. The writ of certiorari should be granted.

Respectfully submitted,

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